No. 721

In the Supreme Court of the United States

OCTOBER TERM, 1942

THE NORTH AMERICAN COMPANY

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION

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The Solicitor General, on behalf of the Securities and Exchange Commission, joins in the petition of The North American Company that a writ of certiorari be issued to review the judgment of the United States Circuit Court of Appeals for the Second Circuit entered January 28, 1943.

1. The suit involves the constitutionality of Section 11 (b) (1) of the Public Utility Holding Company Act of 1935 (49 Stat. 803, herein referred to as the Act) as applied by the Commission to The North American Company in orders

dated April 14 and June 25, 1942. On petitions for review under Section 24 (a) of the Act, the Commission's orders were unanimously affirmed by the Circuit Court of Appeals for the Second Circuit.

As is indicated in Section 1 (c) of the Act, the integration (Section 11 (b) (1)) and corporate simplification (Section 11 (b) (2)) portions of the Act were considered by Congress as the most important provisions of the Act. The two clauses of Section 11 (b) are closely related and involve similar constitutional questions. There is thus a substantial public interest in an early determination of the constitutionality of a crucial provision of an Act designed to integrate and simplify a $15,000,000,000 industry.

There are presently pending in the Circuit Courts of Appeals two cases involving the constitutionality of Section 11 (b) (1) as well as certain questions of construction of that section which arose in the instant case; these cases are *Engineers Public Service Company* v. *S. E. C.*, in the Court of Appeals for the District of Columbia, No. 8394; and *United Gas Improvement Company* v. *S. E. C.*, in the Circuit Court of Appeals for the Third Circuit, Nos. 7888 and 8046. In addition, the following pending cases involve the constitutionality of the related Section 11 (b) (2): *Central and Southwest Utilities Company* v. *S. E. C.*, in the Court of Appeals for the Dis-

trict of Columbia, No. 8333; *American Power and Light Company* v. *S. E. C.* and *Electric Power and Light Company* v. *S. E. C.*, in the Circuit Courts of Appeals for the First Circuit, Nos. 3823 and 3824, respectively; *Commonwealth and Southern Corporation* v. *S. E. C.*, in the Circuit Court of Appeals for the Third Circuit, No. 8052, and *Todd* v. *S. E. C.*, in the Circuit Court of Appeals for the Sixth Circuit, No. 9348.

The Commission has pending before it more than twenty proceedings involving the application of Section 11 (b) (1) of the Act, and more than forty proceedings involving Section 11 (b) (2).

Because of this multiplicity of suits in the Circuit Courts of Appeals, the great number of Section 11 (b) proceedings pending before the Commission, and the public importance of the question, it is desirable that a writ of certiorari be granted in the instant case, and that the case be submitted for decision at this Term.

2. In order to clarify the problems raised by the petition, we believe it advisable to explain at this time the structure of the statute and the scope of the order involved in this case.

The Public Utility Holding Company Act of 1935 provides for the registration of interstate gas and electric utility holding companies. Registration is required of companies which directly (§§ 4 (a) (1)–4 (a) (5)) or through subsidiaries (§ 4 (a) (6)) engage in interstate activity. In-

trastate holding companies may apply for exemption (§§ 3 (a) (1) and (2)). Once a holding company is registered (and not exempted), the Act provides for the regulation of issuance of securities and various other transactions by the holding company and its subsidiaries. Section 11 provides machinery for the limitation of each system to a single geographically integrated system and for the simplification of any unduly complex structure.

The North American Company is one of the largest holding companies subject to this statute. North American controls companies whose assets are carried on their books at more than $2,300,000,000 (R. 85).[1] The system consists of eighty companies, operating chiefly electric and gas utility properties in seventeen states and the District of Columbia (R. 84). Properties of the system are scattered from Washington, D. C., to California, and from northern Michigan to southern Kansas and Missouri (Maps, R. 90, 91). North American is a New Jersey corporation with its principal place of business in New York City (R. 86). North American's interest in its subsidiaries is not merely that of an investor owning securities, as it states. North American controls

[1] However, not all of these companies are included in the consolidated balance sheet of North American and its subsidiaries, which shows assets of approximately $957,000,000 (R. 85).

its subsidiaries.[2] Indeed, control is the essence of the parent-subsidiary relationship under the statute (Sec. 2 (a) (7) and Sec. 2 (a) (8)). And it is clear that, at least with respect to its admitted subsidiaries, the control is actually exercised by North American. Further, in the light of the geographical location of the subsidiaries, the control from the principal office is exercised by means of the instrumentalities of interstate commerce.

The subsidiaries render electric service to more than 3,000,000 customers spread over an area of some 165,000 square miles with a population in excess of 12,000,000 (R. 85). The principal territories served are St. Louis, the District of Columbia, Milwaukee, Cleveland, Detroit, and extensive portions of Illinois, Iowa, Kansas, Missouri, and California. In addition, the North American system includes numerous gas properties and nonutilities including such varied businesses as railroads, coal mines, ice manufacturing, amusement park operation, oil drilling and gasoline extraction (R. 84).

The order of the Commission appealed from (R. 194) required The North American Company to sever its relationship with a number of companies by disposing of its ownership, control, and

[2] The term "control" is used broadly to include controlling influence of the kind mentioned in Sections 2 (a) (7) and 2 (a) (8) of the Act.

holdings of securities issued and properties owned, controlled, or operated by these companies. In substance, the order requires The North American Company to confine itself to the control of a single integrated public-utility electric system in the area of St. Louis and of certain related incidental businesses. It is this order which is contended to be beyond the power of Congress under the commerce clause and in violation of the due process clause. The court below was right, we believe, in rejecting these contentions.

A. Commerce clause

The decision of this Court in *Electric Bond and Share Company* v. *S. E. C.*, 303 U. S. 419, although confined to the provisions of Sections 4 (a) and 5 of the Act, established two propositions relevant to this case: (1) that a corporation is brought within the reach of Congress under the commerce clause when it engages in the transmission of electric energy or gas across state lines, or in rendering to subsidiaries through the use or instrumentality of interstate commerce expert and financial service, or in the sale of securities in interstate commerce; and (2) that whether such activities are carried out by a holding company directly or whether they are carried out by subsidiary companies controlled by the holding company, a holding company is still within the reach of Congress under the commerce clause, for "the constitutional authority confided to Con-

gress could not be maintained if it were deemed to depend upon the mere modal arrangements of those seeking to escape its exercise" (p. 440). North American, as its petition admits, has directly and through its subsidiaries engaged in the type of activities mentioned in the *Bond and Share* case. Since, as has been stated, control over utility subsidiaries is the essential characteristic of a holding company, under the *Bond and Share* decision the activities of the holding company and its subsidiaries are to be regarded for constitutional purposes as what in fact they are—the activities of a single enterprise.

The relation of Section 11 to interstate commerce is direct. Section 11 (b) (1) ordering the limitation of holding company systems to a single system applies only to registered holding companies. As shown above, only holding companies engaged in interstate commerce are required to be registered. Furthermore, Sections 3 (a) (1) and 3 (a) (2) of the Act provide a means by which companies predominantly intrastate in character may obtain exemption from the Act. North American has not sought to obtain such an exemption and, of course, could not. Having registered and not having sought exemption from any provision of the Act, the Commission was entitled to assume, without express findings, that North American was a holding company interstate in nature and engaged in interstate commerce. Congress was entitled to make a similar assumption

as to all holding companies which register and cannot obtain any exemption from registration. It could, therefore, properly apply Section 11 to North American as a "registered holding company" confident that registration was evidence of the interstate character of the company.

North American argues, however, that the particular type of regulation adopted by Section 11 (b) (1) is not reasonably related to the Congressional power over interstate commerce. The answer lies in the determination whether the continued control by a holding company over subsidiary corporations operating in distant areas so affects interstate commerce that Congress may order such control to be terminated or limited in scope. The Commission, of course, made no such finding. Such a finding was unnecessary and would have been improper since Congress itself had made its own findings.

The constitutionality of dispensing with administrative or judicial findings in specific cases where Congress has found that the activities regulated have a direct effect on interstate commerce is well established. *United States* v. *Darby*, 312 U. S. 100, 120–121. The enactment of Section 11 (b) (1) is itself a finding of Congress that the activity regulated affects interstate commerce and that the remedy proposed is one deemed by Congress appropriate to cure the evils which affect interstate commerce. No more specific finding by Congress was necessary. *Wickard* v. *Filburn*, No.

59, this Term, decided November 9, 1942. Nevertheless, Congress spelled out its findings concerning public utility holding companies at some length.

The Congressional findings are set forth in Section 1 of the Act. The Congress found that it was necessary to control public utility holding companies because it found that such companies and their subsidiary companies were affected with a national public interest since, among other things, "their practices in respect of and control over subsidiary companies often materially affect the interstate commerce in which those companies engage" and the extension of "their activities" over "many States * * * make[s] difficult, if not impossible, effective State regulation of public-utility companies." Section 1 further declares that the national public interest is, or may be, adversely affected "when the growth and extension of holding companies bears no relation to economy of management and operation or the integration and coordination of related operating properties."

The Congressional findings expressly incorporate by reference the facts found in a comprehensive 9-year study of the industry set forth in the ninety-odd volumes of the reports of the Federal Trade Commission and in the six-volume Splawn Report of the Committee on Interstate and Foreign Commerce of the House of Representatives.

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The evils set forth in the reports before Congress included inflationary write-ups on the books of operating companies complicating the regulation of rates; acquisitions of properties at grossly inflated prices; financing expansion by issuing excessive amounts of senior securities and insufficient common stock capital, resulting in the abuses of excessive leverage and inequitable distribution of voting power; unduly favorable treatment, in the sale of such securities, to investment bankers, frequently affiliated; preoccupation of management with financial maneuvering rather than efficient production and distribution of gas and electricity and the meeting of local needs; extraction of excessive dividends to maintain top-heavy structures of holding companies, often leading to improper accounting practices, and coupled with exorbitant "service charges"; and, finally, concentration of economic power too large for local regulation and presenting dangers of monopolistic control. In Section 1 (c) of the Act Congress declared it "to be the policy of this title, * * * to meet the problems and eliminate the evils as enumerated in this section, connected with public utility holding companies which are engaged in interstate commerce or in activities which directly affect or burden interstate commerce; and for the purpose of effectuating such policy to compel the simplification of public-utility holding company systems and the elimination therefrom of properties detrimental to the proper functioning of

such systems, and to provide as soon as practicable for the elimination of public-utility holding companies except as otherwise expressly provided in this title."

The elimination of public utility holding companies, except within defined limits, was thus found by Congress to be the appropriate means of striking at these evils. Section 11 (b) (1) insofar as it requires divorcement of holding company control over more than a single integrated public utility system (with exceptions not here pertinent) was one means of dealing with the evils of the holding company-operating company relationship; Section 11 (b) (2), requiring the elimination of holding companies insofar as they constitute unnecessary complexities in the holding company systems, is another means to the same end.

The Congress found that control over subsidiaries by the holding company was exercised by means of interstate commerce and that the evils resulting were initiated and perpetuated by means of instrumentalities of interstate commerce. It further found that these evils affected the nature and volume of the interstate commerce in which the subsidiaries engaged. The studies before it convinced Congress that control by the holding company over its subsidiaries was the root of the evil and it therefore declared that the means to remedy the evil was the limitation of the permissible scope of the holding company device.

Section 11 (b) (1), ordering divestment of properties unrelated to a single integrated public utility system, is not only reasonably related to the desired end, but is, in fact, essential to its accomplishment. The divestment of scattered and unrelated properties will achieve the desired objective of concentrating the attention of management on the efficient operation of "related operating properties" in a single area or region unhampered by absentee control and by problems unrelated to its proper functions. It seems clear from these findings that the particular activity regulated—control through the instrumentality of interstate commerce of a nation-wide holding company system—is within the reach of the federal power and that the type of regulation selected is reasonably designed to cope with the evils arising from the regulated activity.[3]

B. Due process

It is argued that enforcement of the Commission's order would deprive petitioner of important property rights. Although there is no basis for this assumption, nevertheless it has no

[3] There is talk of "destruction of values." It is important to note, however, that compliance with such orders is normally made by reorganization plans of the type which were before this Court in *S. E. C. v. Chenery Corp.*, No. 254, this Term, decided February 1, 1943. All such reorganizations must be made in accordance with a plan which is required to be "fair and equitable" and to be passed upon in this respect by the Commission, and normally by federal District and Circuit Courts of Appeals.

relevance to the question involved, which is whether the statute and order are unreasonable, arbitrary, and capricious. It seems clear that the statute is not subject to attack on this ground. When Congress found that substantial evils affecting interstate commerce resulted from control over far-flung empires by public utility holding companies (Section 1 of the Act), it was not powerless to adopt an appropriate remedy even though the alteration of "vested" property rights might be required. *Continental Ins. Co.* v. *U. S.*, 259 U. S. 156. The remedy of ordering divestment is in fact a familiar one under the Clayton Act, *F. T. C.* v. *Western Meat Co.*, 272 U. S. 554; under the Commodities Clause of the Hepburn Act, *U. S.* v. *Lehigh Valley R. Co.*, 220 U. S. 257; *U. S.* v. *Delaware L. & W. R. Co.*, 238 U. S. 516; and under the Packers and Stockyards Act, *Stafford* v. *Wallace*, 258 U. S. 495.

CONCLUSION

For the foregoing reasons, we believe that the decision below is right, but that the importance of the case makes early review by this Court desirable in the public interest.

Respectfully submitted,

CHARLES FAHY,
Solicitor General.

JOHN F. DAVIS,
Solicitor,
Securities and Exchange Commission.

FEBRUARY 1943.

APPENDIX

The Public Utility Act of 1935, 49 Stat. 803, 15 U. S. C., sec. 79 *et seq.*, provides in pertinent part as follows:

TITLE I—CONTROL OF PUBLIC-UTILITY HOLDING COMPANIES

NECESSITY FOR CONTROL OF HOLDING COMPANIES

SECTION 1. (a) Public-utility holding companies and their subsidiary companies are affected with a national public interest in that, among other things, (1) their securities are widely marketed and distributed by means of the mails and instrumentalities of interstate commerce and are sold to a large number of investors in different States; (2) their service, sales, construction, and other contracts and arrangements are often made and performed by means of the mails and instrumentalities of interstate commerce; (3) their subsidiary public-utility companies often sell and transport gas and electric energy by the use of means and instrumentalities of interstate commerce; (4) their practices in respect of and control over subsidiary companies often materially affect the interstate commerce in which those companies engage; (5) their activities extending over many States are not susceptible of effective control by any State and make difficult, if not impossible, effective State regulation of public-utility companies.

(b) Upon the basis of facts disclosed by the reports of the Federal Trade Commis-

sion made pursuant to S. Res. 83 (Seventieth Congress, first session), the reports of the Committee on Interstate and Foreign Commerce, House of Representatives, made pursuant to H. Res. 59 (Seventy-second Congress, first session) and H. J. Res. 572 (Seventy-second Congress, second session) and otherwise disclosed and ascertained, it is hereby declared that the national public interest, the interest of investors in the securities of holding companies and their subsidiary companies and affiliates, and the interest of consumers of electric energy and natural and manufactured gas, are or may be adversely affected—

(1) when such investors cannot obtain the information necessary to appraise the financial position or earning power of the issuers, because of the absence of uniform standard accounts; when such securities are issued without the approval or consent of the States having jurisdiction over subsidiary public-utility companies; when such securities are issued upon the basis of fictitious or unsound asset values having no fair relation to the sums invested in or the earning capacity of the properties and upon the basis of paper profits from intercompany transactions, or in anticipation of excessive revenues from subsidiary public-utility companies; when such securities are issued by a subsidiary public-utility company under circumstances which subject such company to the burden of supporting an overcapitalized structure and tend to prevent voluntary rate reductions;

(2) when subsidiary public-utility companies are subjected to excessive charges for services, construction work, equipment, and materials, or enter into transactions in

which evils result from an absence of arm's-length bargaining or from restraint of free and independent competition; when service, management, construction, and other contracts involve the allocation of charges among subsidiary public-utility companies in different States so as to present problems of regulation which cannot be dealt with effectively by the States;

(3) when control of subsidiary public-utility companies affects the accounting practices and rate, dividend, and other policies of such companies so as to complicate and obstruct State regulation of such companies, or when control of such companies is exerted through disproportionately small investment;

(4) when the growth and extension of holding companies bears no relation to economy of management and operation or the integration and coordination of related operating properties; or

(5) when in any other respect there is lack of economy of management and operation of public-utility companies or lack of efficiency and adequacy of service rendered by such companies, or lack of effective public regulation, or lack of economies in the raising of capital.

(c) When abuses of the character above enumerated become persistent and widespread the holding company becomes an agency which, unless regulated, is injurious to investors, consumers, and the general public; and it is hereby declared to be the policy of this title, in accordance with which policy all the provisions of this title shall be interpreted, to meet the problems and eliminate the evils as enumerated in this section, connected with public-utility holding companies which are engaged in

interstate commerce or in activities which directly affect or burden interstate commerce; and for the purpose of effectuating such policy to compel the simplification of public-utility holding-company systems and the elimination therefrom of properties detrimental to the proper functioning of such systems, and to provide as soon as practicable for the elimination of public-utility holding companies except as otherwise expressly provided in this title.

DEFINITIONS

SEC. 2. (a) When used in this title, unless the context otherwise requires—

* * * * *

(7) "Holding company" means—

(A) any company which directly or indirectly owns, controls, or holds with power to vote, 10 per centum or more of the outstanding voting securities of a public-utility company or of a company which is a holding company by virtue of this clause or clause (B), unless the Commission, as hereinafter provided, by order declares such company not to be a holding company; and

(B) any person which the Commission determines, after notice and opportunity for hearing, directly or indirectly to exercise (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such person be subject to the obligations, duties, and liabilities imposed in this title upon holding companies.

The Commission, upon application, shall by order declare that a company is not a holding company under clause (A) if the Commission finds that the applicant (i) does not, either alone or pursuant to an arrangement or understanding with one or more other persons, directly or indirectly control a public-utility or holding company either through one or more intermediary persons or by any means or device whatsoever, (ii) is not an intermediary company through which such control is exercised, and (iii) does not, directly or indirectly, exercise (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that the applicant be subject to the obligations, duties, and liabilities imposed in this title upon holding companies. The filing of an application hereunder in good faith by a company other than a registered holding company shall exempt the applicant from any obligation, duty, or liability imposed in this title upon the applicant as a holding company, until the Commission has acted upon such application. Within a reasonable time after the receipt of any application hereunder, the Commission shall enter an order granting, or, after notice and opportunity for hearing, denying or otherwise disposing of, such application. As a condition to the entry of any order granting such application and as a part of any such order, the Commission may require the applicant to apply periodically for a renewal of such order

and to do or refrain from doing such acts or things, in respect of exercise of voting rights, control over proxies, designation of officers and directors, existence of interlocking officers, directors and other relationships, and submission of periodic or special reports regarding affiliations or intercorporate relationships of the applicant, as the Commission may find necessary or appropriate to ensure that in the case of the applicant the conditions specified in clauses (i), (ii), and (iii) are satisfied during the period for which such order is effective. The Commission, upon its own motion or upon application of the company affected, shall revoke the order declaring such company not to be a holding company whenever in its judgment any condition specified in clause (i), (ii), or (iii) is not satisfied in the case of such company, or modify the terms of such order whenever in its judgment such modification is necessary to ensure that in the case of such company the conditions specified in clauses (i), (ii), and (iii) are satisfied during the period for which such order is effective. Any action of the Commission under the preceding sentence shall be by order.

* * * * *

SEC. 11.

* * * * *

(b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:

(1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit

the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system: *Provided, however,* That the Commission shall permit a registered holding company to continue to control one or more additional integrated public-utility systems, if, after notice and opportunity for hearing, it finds that—

(A) Each of such additional systems cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system;

(B) All of such additional systems are located in one State, or in adjoining States, or in a contiguous foreign country; and

(C) The continued combination of such systems under the control of such holding company is not so large (considering the state of the art and the area or region affected) as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation.

The Commission may permit as reasonably incidental, or economically necessary or appropriate to the operations of one or more integrated public-utility systems the retention of an interest in any business (other than the business of a public-utility company as such) which the Commission shall find necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems.

(2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company, or of any company whose principal business is that of a public-utility company.

The Commission may by order revoke or modify any order previously made under this subsection, if, after notice and opportunity for hearing, it finds that the conditions upon which the order was predicated do not exist. Any order made under this subsection shall be subject to judicial review as provided in section 24.

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